CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate –Real Estate Policy for Leverage ITEM NUMBER: 6

ATTACHMENT(S): 3

ACTION: X DATE OF MEETING: September 1, 1999

INFORMATION: ________ PRESENTERS: Mr. Pleis

EXECUTIVE SUMMARY

One of the objectives for the 1999/00 fiscal year is "To develop and present policy for the use of leverage in the moderate and high risk segments of the real estate portfolio".

The Investment Committee adopted the annual business plan for the Real Estate Unit at the May 1999 meeting. One component of the business plan was the use of leverage for directly owned properties in the moderate and high-risk segments of the portfolio.

The Real Estate Policy (Policy) is provided as Attachment 1. There are two proposed additions to the Policy that have been underlined in the text. The first addition is policy #4 on page four of Attachment 1. The second addition is in Exhibit 1 on page seven of Attachment 1.

Approval of this Policy will allow Investment Staff, subject to the $100 million discretionary authority listed in policy #10, to approve all new leverage. Any leverage over $100 million must be presented to the Investment Committee for approval. External managers will have the ability to purchase property with existing leverage as limited in their respective "discretion in a box" guidelines.

Staff will report on a monthly basis all changes, either increases or decreases, in leverage for directly owned properties. Pension Consulting Alliance will incorporate a section on leverage in their semi-annual performance report.

RECOMMENDATION

Staff recommends Investment Committee approval of the proposed Policy changes identified in Attachment 1 by adopting the attached resolution (Attachment 2). Pension Consulting Alliance has reviewed the proposed changes to the Policy regarding leverage and concurs with Staff's recommendation. Attachment 3 summarizes Pension Consulting Alliance's observations on the industry leverage and the appropriateness of leverage in the CalSTRS real estate portfolio.

CalSTRS

CALIFORNIA STATE TEACHERS'
RETIREMENT SYSTEM

REAL ESTATE
POLICY MANUAL

INVESTMENT BRANCH
July 1999

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INTRODUCTION

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (CalSTRS) has established an allocation for investment real estate, an illiquid equity related asset, using internal staff and external specialized professionals. The primary objective for investment real estate is to improve diversification of the overall investment portfolio. The investment real estate portfolio will also have secondary objectives to achieve a rate of return which corresponds to the amount of risk outlined in the real estate portfolio risk/return composite approved by the Investment Committee and to provide a stable cash flow to the investment portfolio.

Investment real estate can be divided into three broad categories of risk: (1) low risk, (2) moderate risk, and (3) high risk. Each risk category contains certain characteristics which have been included as Exhibit 1. CalSTRS investment real estate portfolio will have a strategic target risk/return allocation of 50% low risk, 25% moderate risk and 25% high risk.

CalSTRS investment real estate portfolio may consist of real estate assets purchased and owned by three main investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

The CalSTRS Board has established the asset allocation and strategic objectives for the real estate portfolio. The purchase, management and sale of all types of real estate investments are performed by external professionals which are monitored and evaluated by internal investment officers and an external real estate consultant. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external real estate consultant reports directly to the CalSTRS Board.

This manual will establish the policies involved in the management of investment real estate. The policies are designed to set boundaries for expected performance, diversification, and investment structure. A flow chart is provided to establish context for the policies presented.

INVESTMENT REAL ESTATE POLICIES
May 1999

The following represent approved policies to be utilized in the management of the California State Teachers' Retirement System (CalSTRS) investment real estate portfolio. The policies are designed to set boundaries for the expected performance, diversification and investment structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

1. **Laws and Statutes** - The investment real estate portfolio of the California State Teachers' Retirement System is to be invested, managed and sold in a prudent manner for the sole benefit of CalSTRS participants and beneficiaries in accordance with the Teachers' Retirement law and other applicable statutes. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the investment real estate portfolio.

2. **Role of Investment Real Estate** - The primary role of the investment real estate portfolio is to provide improved diversification to the overall investment portfolio. Secondary objectives are to generate an enhanced yield to the actuarial rate assumption and to provide stable cash flows.

3. **Portfolio Risk Composite** - CalSTRS has established a composite risk range for the investment real estate portfolio. A strategic allocation target of 50% in low risk and a range of 40% to 75%, a 25% target for moderate risk with a range of 10% to 25% and a target of 25% for high risk with a range of 10% to 25% will be used. The definition of the different risk levels has been included as Exhibit 1.

4. **Portfolio Leverage** – CalSTRS may utilize leverage for directly owned, including joint ventures, moderate and high risk real estate assets to enhance investment returns. Consideration will be given to the risk associated with such leverage on the overall real estate portfolio with specific limitations identified in Exhibit 1.

5. **Portfolio Cash Flow** - The projected cash flow for new acquisitions in the low risk portion of the investment real estate portfolio is expected to approximate the actuarial rate assumption over a five-year horizon. Moderate risk and high-risk investments will not be constrained by cash flow targets and will emphasize yield enhancement over a shorter time frame than low risk investments. Exceptions to this policy will be approved in writing by the Chief Investment Officer.

6. **Property Type** - The property types used for direct investments in the real estate portfolio are defined as Industrial, Land, Multi-Family Residential, Natural Resources, Office, Retail, Single Family Residential, and other property types as approved in writing by the Chief Investment Officer.

7. **Geographic Location** - Geographic regions for investing are defined as the location of the individual property. The geographic breakdown is expressed as Mid-West, East, South, West, and International. Properties located outside the United States can be held only in the high risk category.

8. **Investment Ownership Structure** - CalSTRS can invest and hold real estate assets in the following three investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitzed investments.

9. **Diversification Guidelines** - The direct low risk investments contained in the investment real estate portfolio shall have a strategic target and range established for the following diversification criteria: (1) property type and (2) geographic location. The target and range for each criteria are included as Exhibit 2. Purchases or sales shall not be completed for the sole purpose of aligning one specific criteria. Projected rate of return, composite risk profile, and other policies should receive consideration in all transactions. Moderate and high risk investments will not have diversification targets by property type or geographical location.

10. **Investment Limitations** - Graduated limitations of daily buying and selling cash, securities, and properties for aggregate real estate equity investment portfolio transactions are as follows (including lock box transactions):

Associate Investment Officer	$ 5 million
Investment Officer I	$ 10 million
Investment Officer II	$ 25 million
Investment Officer III	$ 50 million
Director of Real Estate	$ 250 million
Chief Investment Officer	$ 1 billion

11. **Discretionary Authority** - The rejection and approval decision for low, moderate and high risk direct ownership properties, co-investments, commingled funds and secondary interests is delegated to Staff with the stipulation that all investments are subject to the appropriate due diligence as defined in the real estate procedures.

    The approval of major capital decisions including the decision to acquire, finance, refinance, renovate, expand, or sell is delegated to Staff considering the following stipulations:

    A. Due diligence process shall be consistent and appropriate as defined in the investment real estate procedures.
    B. Maximum amount of the commitment should not exceed $100 million.
    C. A final recommendation report will be presented to the Investment Committee as soon as practical after the transaction is completed.

D. Direct real estate assets and commingled fund strategies located in the United States.

Staff can delegate the above authority to CalSTRS' real estate managers for the implementation of the low risk investment strategies.

12. **Authorized Signers** - Authorization letters which indicate who may sign on behalf of CalSTRS shall be delivered to the appropriate parties. Whenever a change in authorized signers(s) occurs, the effected parties shall be notified within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer.

13. **Policy Reporting** - CalSTRS' real estate consultant shall monitor the investment policies and report to the CalSTRS Board as requested.

14. **Performance Benchmark** - CalSTRS' shall use the NCREIF Property Index to benchmark real estate investments in the portfolio.

15. **Annual Business Plan** - The Real Estate portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.

16. **Portfolio Reporting -** The real estate consultant will prepare and present a portfolio management report on a semi-annual basis. The management report will evaluate CalSTRS' property and regional diversification and property and partnership performance.

Adopted on June 3, 1998
Amended on__________

Exhibit #1

Investment Real Estate Policies
Definition of Risk Characteristics for Real Estate

Investment real estate can be categorized into a risk and return spectrum comprised of low risk, moderate risk, and high risk. The following table reflects the characteristics of the three categories of risk:

Low Risk

- Expected real rate of return of up to 6% (after inflation)
- Traditional property types (industrial, office, retail and apartments)
- Substantially leased at acquisition (higher than 90% leased)
- No leverage on the property
- Cash flow from property is the largest component of return
- Properties located in large and diverse geographic areas in the U.S.

Moderate Risk

- Expected real rates of return between 6% to 12% (after inflation)
- Traditional and non-traditional property types. Non-traditional property types may include, but are not limited to, timber, hotels, senior housing and mini-storage.
- Partially leased at acquisition (higher than 50%)
- Moderate leverage (up to 60% 50% loan to value)
- May be vacant or construction related (i.e. new development and redevelopment) if the leasing requirement stated above is in place at funding.
- Cash flow and appreciation are both large components of future value
- Geographically concentrated within the U.S.

High Risk

- Expected real rate of return higher than 12% (after inflation)
- Traditional and non-traditional property types. Non-traditional property types may include, but are not limited to, timber, hotels, senior housing and mini-storage.
- May be vacant or construction related (includes new development and redevelopment)
- Moderate to high leverage (between 50% to 90% loan to value)
- Appreciation is the largest component of future value
- Geographically concentrated; potentially international locations

Exhibit #2

Investment Real Estate Policies
Diversification Criteria for the Direct Portfolio

Geographical Location	Range	Target	12/31/98 Actual
• West	30% - 50%	40%	66%
• South	15% - 35%	25%	16%
• East	10% - 30%	20%	10%
• Mid-West	5% - 25%	15%	8%
• International	0% - 10%	0%	0%

Property Type	Range	Target	12/31/98 Actual
• Industrial	15% - 35%	25%	20%
• Apartments	10% - 30%	20%	19%
• Office	30% - 50%	35%	39%
• Retail	15% - 35%	20%	22%
• Other *	0% - 10%	0%	0%

* Other to include Land, Single Family Residential, Natural Resources and Hotels

RESOLUTION OF THE
CALIFORNIA TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Real Estate Policy Modification - Leverage

Resolution No. ___________

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the modified Real Estate Policies specifically identifying the use of leverage, and has heard oral presentations from Staff and Pension Consulting Alliance (PCA); and

WHEREAS, the Staff has recommended the adoption of the modified Real Estate Policies with the addition of specific leverage language; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Real Estate Policies.

Adopted by:

Investment Committee
on ______________________________

____
James D. Mosman
Chief Executive Officer

PENSION CONSULTING ALLIANCE, INC.

M E M O R A N D U M

To:	Investment Committee California State Teachers' Retirement System	Date:	August 13, 1999
From:	Nori Gerardo Lietz Pension Consulting Alliance, Inc.	cc:	Patrick Mitchell Mitch Pleis Terry Sander
RE:	**CALSTRS LEVERAGE POLICY**		

This letter conveys PCA's endorsement of the proposal to apply leverage to the direct and joint venture investments in the moderate-risk strategy and high-risk strategy components of the CalSTRS' real estate portfolio. Leverage guidelines will be set and monitored by the CalSTRS' Investment Staff, who will have discretionary authority for the application of leverage up to $100 million of loan value. Any loan exceeding $100 million will be submitted to the Committee for approval.

CalSTRS currently belongs to a small minority of plan sponsors that do not utilize leverage in their directly owned real estate portfolios. Most large plan sponsors have a segment of their real estate portfolios (generally 25%-30%) in which leverage is aggressively employed. The leverage in that specific component of their portfolio typically ranges from 50% to 75%. Many plan sponsors also incorporate modest leverage (less than 30% loan to value) in their low risk or core portfolios. While CalSTRS historically pursued an all-equity strategy with regards to the directly owned or joint venture assets in an effort to reach the target allocation level in the real estate asset class, its progress toward this goal warrants a re-examination of the leverage policy.

The primary benefit of leverage is to increase investment returns. Leverage can also increase deal flow by providing flexibility and diversity to deal structures and thus widening the array of investment sources and opportunities. Leverage has been and continues to be used for these purposes with recent sound success by most of PCA's real estate clients. Occasionally, favorable debt in place can contribute incremental value all its own to an investment opportunity.

However, it should be recognized that while the use of leverage has the potential to augment investment returns overall, it will increase the volatility of the underlying real estate asset's returns. While in a rising market the volatility should be positive, in a falling market environment the use of leverage will magnify the depreciation component of the return. The greater the leverage ratio the higher the volatility (i.e., risk) associated with the investment.

CalSTRS is in a unique position to manage this risk, however, on the downside. Given CalSTRS' size, the option should exist to pay down some portion of the leverage in a falling market environment to manage this risk. Thus, on balance PCA believes that the potential risks associated with the leverage on direct assets and joint ventures in the moderate and high risk categories are justified by the potential increased returns on those same components. On balance, at the composite real estate portfolio the overall risk profile will not be overly skewed towards the upper end of the real estate risk/return continuum.

PCA concurs with Staff's recommendation for the proposed leverage policy. PCA believes leverage is both an appropriate and effective mechanism for large public pension funds to potentially increase returns and deal flow.